Report No. 1285

New York State Bar Association Tax Section

Report on

Proposed Regulations Section 1.1411-10

May 22, 2013

Report on Proposed Regulations Section 1.1411-10

This report (the "Report")[1] provides comments on Proposed Treasury regulation Section 1.1411-10 issued on December 3, 2012 (the "Proposed Regulations").[2] The Proposed Regulations provide rules for how distributions and income inclusions arising from an individual's investment in a controlled foreign corporation ("CFC") or a passive foreign investment company ("PFIC") are to be taken into account in computing the individual's "net investment income" under Section 1411 of the Internal Revenue Code of 1986, as amended (the "Code").[3] The Proposed Regulations are part of a larger package of proposed regulations issued under Section 1411, and we commented on other aspects of that package of proposed regulations in a separate report.[4]

Part I of this Report summarizes the statutory background to the Proposed Regulations and Part II describes the Proposed Regulations. Part III of the Report contains a summary of, and detailed discussion of, our recommendations and comments. Part IV addresses whether the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") have the authority to adopt our primary recommendation (which is to issue regulations that would treat income inclusions derived from a CFC or PFIC as currently includible dividend income for Section 1411 purposes).

Our comments on the Proposed Regulations are limited to the provisions relating to CFCs and to PFICs as to which an individual has made a timely QEF election. At this time, we have no comments on the provisions of the Proposed Regulations that apply in the case of a PFIC where the individual has not made a timely QEF election, and we are not commenting on the provisions applicable to trust and estates that hold stock of CFCs or PFICs.

I. Summary of the Statutory Background.

A. Section 1411. Section 1411 was enacted in 2010 and put into a new Chapter 2A of Subtitle A of the Code, titled "Unearned Income Medicare Contribution."[5] Generally, Section 1411 imposes a new 3.8% "Medicare contribution tax" on the unearned income of individuals, estates and trusts. Specifically, under Section 1411(a), beginning in 2013, certain individuals, estates and trusts will be required to a pay a 3.8% tax on their "net investment

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[1] The principal drafter of this Report was Lisa A. Levy. Helpful comments were received from Kimberly Blanchard, Douglas Borisky, Peter Connors, Stephen B. Land, Stuart Rosow, Michael Schler, David Schnabel, David Sicular, Willard Taylor, Richard Upton and Diana Wollman. This letter reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

[2] Fed. Reg. Vol. 77, No. 234, p. 72611.

[3] All references to "sections" herein are references to sections of the Code or the Treasury Regulations promulgated or proposed thereunder.

[4] See New York State Bar Association Tax Section, *Report on the Proposed Regulations under Section 1411* (May 15, 2013) (the " Main 1411 Report").

[5] Pub. L. No. 111-152, 124 Stat. 1029 (2010). Chapter 1 of Subtitle A of the Code consists of Sections 1 through 1400U-3, and Chapter 2 of Subtitle A of the Code consists of Sections 1401-1402.

income" for the taxable year.[6] Under Section 1411(c), "net investment income" ("NII") includes (a) the sum of (1) gross income from interest, dividends, annuities, royalties and rents, other than such income derived in the ordinary course of a trade or business that is neither a passive activity with respect to the taxpayer nor a trade or business of trading in financial instruments or commodities (collectively, "Category 1 Income"), (2) other gross income derived from a trade or business that is a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities (collectively, "Category 2 Income"), and (3) net gain attributable to the disposition of property, other than property held in a trade or business that is neither a passive activity with respect to the taxpayer nor a trade or business of trading in financial instruments or commodities (collectively, "Category 3 Net Gain"), over (b) allowable deductions properly allocable to such gross income or net gain.

B. Controlled Foreign Corporations. Under Section 951(a), an individual who is a "United States shareholder" of a CFC[7] on the last day of a taxable year generally will include in her gross income in such taxable year for purposes of chapter 1 of the Code ("Chapter 1") her pro rata share of the CFC's subpart F income[8] (referred to herein as "Subpart F Inclusions") for the taxable year, regardless of whether that income is distributed to the individual by the CFC. Under Section 952(c)(1), a CFC's subpart F income for any taxable year is limited to the CFC's earnings and profits for such taxable year. Under Section 959(a), for Chapter 1 purposes, distributions of a CFC's earnings attributable to Subpart F Inclusions that are, or have been, included in the gross income of a United States shareholder (referred to herein as "PTI") are excluded from the United States shareholder's gross income (or the gross income of any other United States person that acquires any portion of such United States shareholder's CFC stock subject to such acquirer satisfying the IRS of her right to such exclusion[9]). Under Section 961, a

[6] More specifically, an individual will be required to pay a 3.8% tax on the lesser of (a) the individual's net investment income for the taxable year, or (b) the excess (if any) of (i) the individual's modified adjusted gross income for the taxable year over (ii) $250,000, in the case of an individual filing a joint return or as a surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under Section 911(a)(1) (net of the deductions and exclusions disallowed with respect to foreign earned income).

[7] A foreign corporation generally is a CFC if, on any day during the taxable year of the foreign corporation, more than 50% (by vote or value) of the foreign corporation is owned (or is treated as owned under applicable constructive ownership rules) by one or more "United States shareholders". Section 957. A "United States shareholder" is a United States person that owns (or is treated as owning under applicable constructive ownership rules) 10% or more (by vote) of the CFC. Section 951(b).

[8] Subpart F income consists of a certain type of insurance income under Section 953 and, under Section 954, foreign personal holding company income, foreign base company sales income, foreign base company services income and foreign base company oil related income, in each case reduced by deductions (including taxes) properly allocable to such income. Subject to certain exceptions, foreign personal holding company income generally includes dividends, interest, annuities, certain royalties and rents, net gains from the disposition of property that produce the foregoing types of income, net gains from certain commodity transactions, net gains from certain foreign currency transactions, net gains from forwards, futures or options, net income from certain swap transactions, substitute dividends, and income equivalent to interest (including substitute interest payments and commitment fees for loans made). Section 954(c); Reg. Section 1.954-2.

[9] See Reg. Section 1.959-1(d) (providing that this exclusion from gross income applies to a United States person that acquires any portion of an interest in a CFC from a United States shareholder to the extent the acquiring

United States shareholder's Subpart F Inclusions with respect to a CFC increase the United States shareholder's tax basis in the stock of the CFC (or in the property resulting in the United States shareholder being treated as constructively owning the stock of the CFC), and distributions of PTI from the CFC decrease the United States shareholder's tax basis in the stock of the CFC (or in such property); to the extent that a distribution of PTI from a CFC exceeds the United States shareholder's tax basis in the stock of the CFC (or in such property), the excess is treated as gain from the sale or exchange of property. In addition, under Section 959(d), for purposes of Chapter 1, a distribution of PTI from a CFC is treated as a distribution that is not a dividend, but the distribution reduces the CFC's earning and profits. Finally, under Section 1248, all or a portion of an individual's gain recognized from the sale of stock of a foreign corporation may be treated as a dividend (referred to herein as a "<u>Section 1248 Dividend</u>"), and Section 959(e) provides that, for purposes of Section 959, the amount of an individual's Section 1248 Dividend is treated as a Subpart F Inclusion of the individual with respect to the foreign corporation.

C. <u>Passive Foreign Investment Companies</u>. A foreign corporation generally is a PFIC for any taxable year if either (1) 75% or more of its gross income for the taxable year is "passive income" or (2) 50% or more of its assets produce, or are held for the production of, "passive income".[10] Under Section 1293(a), an individual who owns stock of a PFIC at any time during a taxable year and timely makes an election to treat the PFIC as a "qualified electing fund" ("<u>QEF</u>")[11] generally will include in his gross income in such taxable year his pro rata share of the PFIC's ordinary earnings (treated as ordinary income) and net capital gain (treated as long-term capital gain) (referred to herein as "<u>QEF Inclusions</u>") for such taxable year, regardless of whether the PFIC actually distributes such income to him.[12] Under Section 1293(e), a QEF's ordinary earnings and net capital gain for a taxable year is limited to the QEF's earnings and profits for such taxable year. Under Section 1293(c), if a taxpayer establishes to the satisfaction of the IRS that a distribution by a QEF is attributable to earnings and profits that are or were included in the gross income of any United States person pursuant to a QEF election (also referred to herein as "<u>PTI</u>"), then the distribution is not treated as a dividend for purposes of Chapter 1, but the distribution reduces the earnings and profits of the PFIC. Finally, under

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person establishes to the satisfaction of the IRS the right to the exclusion and describing the information required to be furnished to the IRS to support the exclusion). See also Prop. Reg. Section 1.959-1(b)(5).

[10] Section 1297(a). Subject to certain exceptions, "passive income" for this purpose generally has the same meaning as foreign personal holding company income. See footnote 8 above.

[11] A U.S. shareholder of a PFIC, regardless of the size of his ownership interest in the PFIC, will be subject to a potentially punitive tax regime under Section 1291, unless the U.S. shareholder makes a QEF election pursuant to Section 1295 or a "market-to-market" election pursuant to Section 1296 with respect to the PFIC.

[12] Section 1293. An individual's pro rata share of a QEF's ordinary earnings and net capital gain for a taxable year generally is the amount that the QEF would distribute to the individual with respect to her QEF stock if, on each day during the taxable year, the QEF distributed to each shareholder a pro rata share of that day's ratable share of the QEF's ordinary earnings and net capital gain for the taxable year. Section 1293(b). In order for a U.S. shareholder of a PFIC to make a QEF election, the PFIC has to provide the U.S. shareholder with (1) information concerning the U.S. shareholder's pro rata share of the PFIC's earnings for the taxable year and the amount of cash and the fair market value of other property distributed or deemed distributed to the U.S. shareholder during the taxable year and (2) permission to inspect and copy the PFIC's books and records. In addition, the PFIC's ordinary earnings and net capital gain must be computed using U.S. federal income tax accounting principles. Reg. Section 1.1295-1.

Section 1293(d), an individual's QEF Inclusions with respect to a PFIC increase the individual's tax basis in the stock of the PFIC (or in the property resulting in the individual being treated as constructively owning the stock of the PFIC), and distributions of PTI decrease the individual's tax basis in the stock of the PFIC (or in such property).

II. Summary of the Proposed Regulations.

A. Treatment of Subpart F Inclusions and QEF Inclusions. The rules set out in the Proposed Regulations for applying Section 1411 to income and gains derived from CFCs and PFICs are extremely complex. This complexity emanates primarily from the Proposed Regulations' approach to Subpart F Inclusions and QEF Inclusions. The preamble to the Proposed Regulations (the "Preamble") is very clear and very helpful in explaining the rationale for this approach and the complex rules that result from this approach. Based upon the Preamble's explanation, the Proposed Regulations' approach and the rationale for that approach can be summarized as follows:

(i) the Code does not refer to Subpart F Inclusions and QEF Inclusions as "dividends" or provide that they should be treated "as dividends";

(ii) Section 1411(c)(i), in defining Category 1 Income, uses the word "dividends" and, because Subpart F Inclusions and QEF Inclusions are not dividends under the Code, they cannot be treated as dividends for this purpose;

(iii) distributions of PTI (by CFCs and QEFs) are also not "dividends" under the Code, but, if not for the special rules in Sections 959 and 1293, distributions of PTI *would be* dividends under the general rules in the Code;

(iv) in applying Section 1411, we can disregard the special rules in Sections 959 and 1293 because these apply only for Chapter 1 purposes, and we can follow the normal Code rules for defining a dividend and, accordingly, treat distributions of PTI *as* dividends (and thus as Category 1 Income);

(v) given the effective date of Section 1411, distributions of PTI (in 2013 and later years) that are attributable to amounts included as Subpart F Inclusions or QEF Inclusions in Chapter 1 gross income in years before 2013 should not be includible in NII;

(vi) distributions of PTI attributable to amounts included as Subpart F Inclusions or QEF Inclusions in Chapter 1 gross income in 2013 and later years should be includible in NII.

This approach to Subpart F Inclusions and QEF Inclusions creates a divergence between the Chapter 1 treatment of those amounts and the Section 1411 treatment of those amounts. In order to address the consequences of this divergence, a handful of additional special rules are added, including:

(a) a special rule for adjusting the computation of "modified adjusted gross income" that backs out Subpart F Inclusions and QEF Inclusions and adds in distributions of PTI that are treated as dividends for Section 1411 purposes;

(b) a special rule for determining which year's earnings (pre-2013 and post-2012) distributions of PTI are attributable to (rather than following the Section 959 and Section 1293 approaches);

(c) special rules for determining a shareholder's basis for Section 1411 purposes in stock of a CFC or QEF, and special rules for computing the amount of gain or loss to be included in NII when the stock is sold (using the special Section 1411 tax basis);

(d) a special rule for applying Section 1248 to the sale of stock of a CFC to determine how much of the gain is Category 1 Income as a Section 1248 Dividend instead of being included in Category 3 Net Gain (because the underlying earnings that are PTI attributable to 2013 and later years are not taken into account in applying Section 1248 under Chapter 1 but are taken into account in applying Section 1248 under Chapter 2A) (pre-2013 PTI is taken into account in applying Section 1248 under Section 1411);

(e) a placeholder for potentially adding a special rule to match, under Section 1411, the timing of "properly allocable deductions" attributable under Chapter 1 in a given year to Subpart F Inclusions and QEF Inclusions included in Chapter 1 income in that year (but not included in NII in that year); and

(f) special rules for applying Section 1411 when CFC or QEF stock is held in a partnership or S corporation.

As a final complication, if the Subpart F Inclusions or QEF Inclusions are derived by the taxpayer from a Section 1411 Business,[13] then that income is included in the taxpayer's NII in the same year it is included in Chapter 1 gross income (but as Category 2 "other income" from a Section 1411 Business).

The Proposed Regulations do provide a taxpayer with the ability to conform the Chapter 1 and Chapter 2A treatment of Subpart F Inclusions and QEF Inclusions by making an election under Prop. Reg. Section 1.1411-10(g) (referred to as a "G Election"). If the G Election is made, all the special rules referred to above are not applicable.

[13] A Section 1411 Business means an active trade or business the income from which is included in the taxpayer's NII under Section 1411.

B. Treatment of Individual Who Makes an G Election. Under the Proposed Regulations, if an individual makes a G Election, then (i) all Subpart F Inclusions and ordinary income QEF Inclusions are included in Category 1 Income in the same year they are included in Chapter 1 gross income, and (ii) all capital gain QEF Inclusions are included in Category 3 Net Gain in the same year they are included in Chapter 1 gross income.[14] When an individual makes this election, the regular Chapter 1 rules for computing tax basis in the stock of a CFC or QEF apply. The election, if made, applies to all of the individual's interests in CFCs and QEFs held (directly or indirectly) in the taxable year of the election or acquired in subsequent taxable years.[15]

The election is required to be made for the first taxable year beginning after December 31, 2013 during which the individual directly or indirectly holds stock of a CFC or PFIC and the individual is subject to tax under Section 1411 or would be subject to tax under Section 1411 if the election were made in respect of the CFC or QEF stock.[16] The election must be made on or before the due date (including any extensions) for the filing of the individual's tax return for the year taxable year for which the election is made, and applies to all taxable years for which it is made and all subsequent taxable years, unless revoked with the consent of the IRS.[17]

C. Treatment of an Individual Who Does Not Make a G Election. If an individual does not make a G Election, the individual's Subpart F Inclusions and QEF Inclusions are not taken into account in computing the individual's NII. Rather, for purposes of calculating the individual's NII, the Proposed Regulations treat as a dividend (included in Category 1 Income) a distribution received by the individual from a CFC or QEF that is attributable to PTI included as a Subpart F Inclusion or a QEF Inclusion in the individual's gross income for Chapter 1 purposes in a taxable year beginning after December 31, 2012.[18] For this purpose, distributions of PTI are considered first attributable to any earnings and profits of the CFC or QEF for the current taxable year and then attributable to earnings and profits of the CFC or QEF for prior taxable years beginning with the most recent taxable year.[19]

Because an individual's Subpart F Inclusions and QEF Inclusions are not taken into account in computing the individual's NII, the Proposed Regulations contain special rules for computing the individual's tax basis in the stock of a CFC or QEF. For purposes of calculating the individual's Category 3 Net Gain, as well as whether a portion of any gain is treated as a Section 1248 Dividend (included in Category 1 Income), the individual's tax basis in the stock of a CFC or QEF (or in property resulting in the individual being treated as constructively owning the stock) is not increased by Subpart F Inclusions and QEF Inclusions included in the

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14 Prop. Reg. Section 1.1411-10(g)(1).

15 Id.

16 Prop. Reg. Section 1.1411-10(g)(3). Under a transition rule, an individual also may make this election for the individual's 2013 taxable year . Id.

17 Prop. Reg. Section 1.1411-10(g)(2) and (3).

18 Prop. Reg. Section 1.1411-10(c)(2)(i). A distribution received by the individual from a CFC or QEF that is attributable to PTI included as a Subpart F Inclusion or a QEF Inclusion in the individual's gross income for Chapter 1 purposes in a taxable year prior to 2013 would not be included in NII.

19 Id.

individual's gross income for Chapter 1 purposes in taxable years beginning after December 31, 2012, and is not decreased by distributions of PTI treated as dividends for purposes of Section 1411.[20] In addition, Section 1248(d)(1) and (d)(6) exclude undistributed PTI from a foreign corporation's earnings and profits for purposes of Section 1248(a), but for Section 1411 purposes this exclusion applies only to undistributed PTI attributable to amounts included in gross income for Chapter 1 purposes in a taxable year beginning before December 31, 2012.[21]

The following examples illustrate application of the Proposed Regulations to an individual who does not make a G Election.

Example 1.

(a) Years Preceding the Effective Date of Section 1411
On January 1, 2011, Lisa forms CFC[22] and acquires 100% of the stock of CFC in exchange for a $100 capital contribution. In 2011 and 2012, CFC generates $4 and $8, respectively, of Subpart F Inclusions and has no other earnings and profits. The Subpart F Inclusions increase Lisa's tax basis in the stock of CFC to $112. CFC makes no distributions in 2011 or 2012. Lisa does not make a G Election.

(b) 2013
In 2013, CFC generates $5 of Subpart F Inclusions and has no other earnings and profits. CFC makes no distributions in 2013.
For Chapter 1 purposes, Lisa includes $5 of Subpart F Inclusions in her gross income and her tax basis in the stock of CFC increases by $5 from $112 to $117.
For Section 1411 purposes, Lisa starts with a tax basis of $112 in the stock of CFC (i.e., her tax basis includes Chapter 1 Subpart F Inclusions for taxable years prior to 2013); her tax basis remains at $112 (no increase for the $5 of Subpart F Inclusions in 2013).

(c) 2014
In 2014, CFC generates $12 of Subpart F Inclusions and has no other earnings and profits. CFC distributes $10 to Lisa. For Chapter 1 purposes, Lisa includes $12 of Subpart F Inclusions in gross income and excludes the $10 distribution from her gross income as PTI. For Chapter 1 purposes, her tax basis in the stock of CFC increases to $119 (tax basis at the end of 2013 of $117, plus $12 of Subpart F Inclusions, minus $10 of PTI distribution).

For Section 1411 purposes, the entire $10 distribution is included in Lisa's Category 1 Income as a dividend because it is all treated as attributable to CFC's earning and profits for 2014. For Section 1411 purposes, Lisa's tax basis in the stock of CFC

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20 Prop. Reg. Section 1.1411-10(c)(3)(iii), (c)(4)(i) and (d)(1).

21 Prop. Reg. Section 1.1411-10(c)(4)(ii).

22 In the examples throughout this report, "CFC" or "PFIC" is used to refer to a hypothetical foreign corporation that is a CFC or PFIC, respectively, for U.S. federal income tax purposes.

remains at $112 (because the entire distribution is treated as a dividend for this purpose).

Example 2. Same facts as Example 1. On January 1, 2015, Lisa sells all of the stock of CFC for $135 to Kim.

(a) Chapter 1 consequences: Lisa's gain is $16 ($135 of amount realized minus Chapter 1 tax basis of $119). CFC's undistributed earnings and profits is $19 and, under Section 1248(d)(1), all of it is excluded from the Section 1248 computation because all of it has been included in Lisa's gross income as Subpart F Inclusions. Accordingly, all of Lisa's $16 of gain is long-term capital gain.

(b) Section 1411 consequences: Lisa's gain is $23 ($135 of amount realized minus $112 of Section 1411 tax basis). CFC's undistributed earnings and profits are $19. For Section 1411 purposes, the exclusion under Section 1248(d)(1) applies only to undistributed PTI attributable to amounts included in Lisa's gross income for Chapter 1 purposes in a taxable year beginning before December 31, 2012, which is $12 (attributable to 2011 and 2012). Accordingly, undistributed (and untaxed) earnings and profits for Section 1411 purposes is $7. Therefore, $7 of the gain is a Section 1248 Dividend included in her Category 1 Income and $16 is long-term capital gain included in her Category 3 Net Gain.

The Proposed Regulations also contain tax basis rules applicable to an individual who is a shareholder of an S corporation, or owns directly or indirectly (through one or more tiers of passthrough entities) an equity interest in a domestic partnership, that holds stock of a CFC or QEF. When the individual does not make a G Election, the individual includes in Category 1 Income the individual's share of distributions to the S corporation or partnership from a CFC or QEF that are treated as dividends for purposes of Section 1411.[23] Accordingly, the individual does not increase her tax basis in the stock of an S corporation or an equity interest in a domestic partnership by her share of Subpart F Inclusions or QEF Inclusions included in the S corporation's or partnership's income for taxable years beginning after December 31, 2012.[24] Rather, the individual's tax basis in the S corporation stock or equity interest in the domestic partnership is increased by her share of distributions to the S corporation or partnership from a CFC or QEF that are treated as dividends (Category 1 Income) for purposes of Section 1411. For purposes of determining the individual's NII under Section 1411 and the Proposed Regulations, the individual's tax basis in the S corporation stock or partnership interest as so calculated is used to determine all tax consequences related to tax basis (e.g., loss limitation rules and the characterization of distributions from the S corporation or partnership).[25]

Similarly, the Proposed Regulations also contain tax basis rules that apply to a domestic partnership or an S corporation that owns stock of a CFC or QEF when a direct or indirect partner of the partnership or shareholder of the S corporation is an individual who has not made a

23 Prop. Reg. Section 1.1441-10(c)(2)(i); and Prop. Reg. Section 1.1411-1(a).

24 Prop. Reg. Section 1.1411-10(d)(2) and (d)(3); see Sections 705(a)(1)(A) and 1367(a).

25 Prop. Reg. Section 1.1411-10(d)(2) and (3).

G Election.[26] In computing the individual's share of gain or loss from the S corporation's or partnership's disposition of the stock of a CFC or QEF, the S corporation or partnership does not increase its tax basis in the stock of the CFC or QEF (or in property resulting in the partnership or S corporation being treated as constructively owning the stock) by PTI included in the partnership's or S corporation's gross income for Chapter 1 purposes for taxable years beginning after December 31, 2012, and does not decrease its tax basis in the stock of the CFC or QEF (or in such property) by distributions treated as dividends (Category 1 Income) for purposes of Section 1411 (the "Section 1411 Recalculated Basis").[27]

The following example illustrates application of these rules in the context of a domestic partnership that owns stock of a CFC.

> Example 3. On January 1, 2012, Lisa and Diana form domestic Partnership by each contributing $50 to Partnership for a 50% interest. Partnership forms CFC and owns 100% of the stock of CFC acquired for a $100 capital contribution. Lisa makes a G Election and Diana does not make this election.
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> In 2012, CFC generates $12 of subpart F income and has no other earnings and profits. CFC makes no distributions. Partnership has no other partnership income in 2012 and makes no distributions. Diana's and Lisa's share of Partnership's Subpart F Inclusions are $6 each. Each of Diana and Lisa increase her tax basis in her interest in Partnership by $6 to $56. Partnership increases its tax basis in CFC by $12 to $112.
>
> In 2013, CFC generates $8 of subpart F income and has no other earnings and profits. In 2013, CFC distributes $4 to Partnership, and Partnership makes no distributions.
>
> (a) 2013 Chapter 1 consequences: Diana's and Lisa's share of Partnership's Subpart F Inclusions are $4 each. Each of Diana and Lisa increase her tax basis in her interest in Partnership by $4 to $60. Partnership increases its tax basis in CFC by $4 ($8 of Subpart F Inclusion minus $4 of PTI distribution) to $116.
>
> (b) 2013 Section 1411 consequences: Because Lisa made a G Election, her Section 1411 consequences are the same as her Chapter 1 consequences. Diana's $2 share of the distribution CFC made to Partnership is treated as a dividend included in Diana's Category 1 Income. Diana's tax basis in her interest in Partnership is increased by the $2 of dividend included in her Category 1 Income so her tax basis in her interest in Partnership is $58 for Section 1411 purposes. The Partnership's Section 1411 Recalculated Basis in the CFC stock remains at $112 and must be tracked by the Partnership so that it can compute Diana's Section 1411 consequences upon the Partnership's disposition of any of the stock of CFC.

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[26] Prop. Reg. Section 1.1411-10(d)(1) provides that, when the individual makes a G Election, the individual's share of the partnership's or the S corporation's gain or loss for section 1411 purposes is the same as that for Chapter 1 purposes.

[27] Prop. Reg. Section 1.1411-10(d)(1).

III. Summary of Recommendations

The following summarizes the main recommendations we make in this Report.

- We urge Treasury and the IRS to issue regulations under Section 1411 that treat Subpart F Inclusions and QEF Inclusions as currently includible in Category 1 Income (or Category 3 Net Gain in the case of long-term capital gain QEF Inclusions). We discuss in detail why we think that Treasury and the IRS have the authority to issue such regulations. We think that this change would significantly improve the operation of Section 1411. (Section V.)

- We agree with the Proposed Regulations that if an individual holding QEF stock does not make a G Election, distributions of PTI that corresponds to QEF Inclusions that were treated as long-term capital gain to the individual under Chapter 1 should be treated as Category 1 Income under Chapter 2A (not as Category 3 Net Gain, as would occur if the individual made the G Election). (Section IV.A.)

- The Proposed Regulations should include analogs to Sections 959(a) and (e) and 1293(c) to prevent the earnings and profits of CFCs and QEFs from being included in the NII of the CFC's or QEF's U.S. shareholders more than once. (Section IV.B.)

- The way in which the rule in Prop. Reg. Section 1.1411-10(c)(4) applies should be clarified by providing an example that illustrates that the reference in Prop. Reg. Section 1.1411-10(c)(4) to no G Election being made is referring to the individual whose consequences are being determined. The example should, like our Example 9, posit a shareholder who (i) acquires stock of a CFC from a stockholder who did not make a G Election, (ii) makes a G Election, and (iii) subsequently sells the stock at a time when the CFC has earnings and profits that were included in the initial stockholder's income for Chapter 1 purposes but not for Section 1411 purposes. (Section IV.C.)

- The rules governing the making of untimely G Elections should follow closely the rules governing the making of untimely QEF Elections, so that (i) relief under Reg. Section 301.9100 is not available, (ii) the three retroactive election methods available to a PFIC stockholder who wants to make a retroactive QEF election also apply with respect to retroactive G Elections, and (iii) the PFIC "cleansing elections" that permit a stockholder of a PFIC to remove the taint of pre-QEF years should be copied by permitting a stockholder to make a "cleansing" G Election under rules that mirror those governing a PFIC cleansing election. (Section IV.E.)

- S corporations and domestic partnerships should be permitted to make G Elections at the entity level that would bind their respective shareholders and direct and indirect partners with respect to income and gain derived from their investments in CFCs and QEFs. We believe that this would improve the administrability of the Proposed Regulations. Because an individual's G Election applies to all of the individual's interests in CFC and PFICs and cannot be revoked without the consent of the IRS, consideration should be given to including anti-abuse rules to prevent individuals from using S corporations and domestic partnerships to "cherry pick" which CFCs or PFICs will be subject to G Elections. (Section IV.F.1.)

- The regulations should contain an example illustrating the operation of Section 751 (taking into account Section 1248) when a partner sells an interest in a partnership that holds CFC stock because the results are so non-intuitive that the clarity would be helpful. (Section IV.F.2.)

IV. Comments

As indicated above, our primary recommendation is that Treasury and the IRS issue regulations that treat Subpart F Inclusions and QEF Inclusions as included in NII in the same year in which they are includible in gross income under Chapter 1. In other words, the regulations would eliminate both the difference between the Chapter 1 and Chapter 2A treatment of those inclusions and the ability to elect into consistent treatment, and instead would require consistent treatment for all taxpayers. We address that recommendation last however. First, we address the Proposed Regulations rules for Subpart F Inclusions and QEF Inclusions and, assuming those rules are retained, we investigate whether any specific changes are required in order for them to operate appropriately and as we believe Treasury and the IRS intended.

A. <u>Character of PTI Distributed by a QEF If No G Election is Made</u>. For Chapter 1 purposes, an individual's QEF Inclusions are, to the extent attributable to her pro rata share of the QEF's net capital gain, treated as long-term capital gain to the individual. Similarly, for Section 1411 purposes, if an individual has made a G Election, the individual includes these QEF Inclusions in Category 3 Net Gain (*i.e.*, the character of these QEF Inclusions as gain from the disposition of property is preserved). This means that the individual's losses from the disposition of property taken into account in computing the individual's Category 3 Net Gain are available to offset these QEF Inclusions.[28] By contrast, when an individual who has made a QEF election does not make a G Election, the individual treats a distribution from a QEF entirely as Category 1 Income,[29] regardless of the extent to which the distributed PTI was attributable to the individual's QEF Inclusions treated as long-term capital gain for Chapter 1 purposes. This means that the individual's losses from the disposition of property includible in computing Category 3 Net Gain are not available to offset the individual's Category 1 Income. This is illustrated by the following example:

> <u>Example 4.</u> Lisa owns stock of a PFIC as to which she has made a timely QEF election. In 2013, Lisa's share of the QEF's ordinary earnings and net capital gain are \$8 and \$5, respectively. In 2013, Lisa has a long-term capital loss of \$5 from another

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[28] Prop. Reg. Section 1.1411-10(g)(1); Prop. Reg. Section 1.1411-4(a)(iii) and (d).

[29] Unless the distribution is attributable to PTI that was included in the individual's gross income for Chapter 1 purposes in a taxable year beginning before December 31, 2012, in which case the distribution is not included in the computation of NII.

investment (a Category 3 loss) and no other relevant tax items. On December 31, 2013, the QEF distributes $13 to Lisa.

In 2013, for Chapter 1 purposes, Lisa has $8 of ordinary income and zero capital gain or loss (i.e., her capital gain QEF Inclusion is fully offset by her $5 of long-term capital loss).

(i) Section 1411 consequences when Lisa makes a G Election. Lisa has $8 of Category 1 Income. Lisa has zero Category 3 Net Gain because her $5 of capital gain QEF Inclusion (a Category 3 Net Gain) is fully offset by her $5 of long-term capital loss. Thus, her NII is $8.

(ii) Section 1411 consequences when Lisa does not make a G Election. The entire $13 distribution is treated as a dividend included in Lisa's Category 1 Income. Her NII is $13, because her $5 of long-term capital loss does not offset her Category 1 Income.[30]

Example 5. Same facts as Example 4, except the corporation is a domestic corporation that is a "regulated investment company" for U.S. federal income tax purposes ("RIC") instead of a PFIC. The $13 distribution Lisa receives on December 31, 2013 is reported by the RIC on Form 1099DIV as $8 of an ordinary dividend and $5 of a capital gain dividend.

In 2013, for Chapter 1 purposes, Lisa has $8 of dividend income and zero capital gain or loss (i.e., her capital gain dividend is fully offset by her $5 of long-term capital loss).

In 2013 for Section 1411 purposes, Lisa has $8 of Category 1 Income and zero Category 3 Net Gain because her $5 of capital gain dividend (which the Preamble tells us is included in Category 3 Net Gain) is fully offset by her $5 of long-term capital loss. Lisa has $8 of NII. Thus, in the case of a RIC, the Section 1411 results match the Chapter 1 results (similar to what happens in the case of a PFIC as to which a G Election is made (illustrated in Example 4 clause (i) above).

The QEF rules were designed to give a U.S. investor who makes a QEF election tax results comparable to those she would have had if she had invested in stock of a RIC.

Under the RIC regime, the RIC will usually distribute (or deem distribute) all of its earnings every year and those earnings will be subject to a single layer of U.S. federal income tax – at the shareholder level.[31] An important element of both the RIC regime and the QEF

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30 We note that, in this case, the $5 of long-term capital loss will never available in the future to be used in computing NII. This issue is addressed in the Main 1411 Report.

31 In order for a domestic corporation to qualify as a RIC, among other requirements, (1) at least 90% of the corporation's gross income for each year must consist of dividends, interest, gains from the sale of stock or securities or income from similar sources,[31] and (2) the corporation must timely distribute to its shareholders in each taxable year at least 90% of its net ordinary income and net short-term capital gains in excess of net long-term

regime is that net capital gains derived by the RIC or QEF retain their character as long-term capital gain when those earnings are included in the stockholders' gross income. The legislative history to the QEF rules indicate that the preservation of character was intended to make the taxation of a QEF's earnings comparable to that of a RIC: "Consistent with the committee's intention not to disadvantage U.S. persons who invest in a PFIC rather than a domestic investment company, the bill provides that a U.S. person can segregate his share of the PFIC's current earnings and profits into long-term and short-term capital gain income and ordinary income generated by the PFIC." [32]

If an individual makes a QEF election, then character is preserved for Chapter 1 purposes. If the individual makes a G Election, then character is also preserved for Section 1411 purposes. The question is whether the Proposed Regulations should preserve the character for all Section 1411 purposes even when the individual does not make a G Election. Under the Proposed Regulations, if no G Election is made, the entire distribution of PTI is included in Category 1 Income (as a dividend). Instead, the regulations could preserve character, treating the PTI distribution as ordinary income and long-term capital gain, on a proportionate basis, according to the character of the QEF's earnings out of which the distribution was made as determined under Prop. Reg. Section 1.1411-10(c)(2)(i). Alternatively, a rule preserving character could be limited to a QEF's distributions that are made in the same taxable year as the underlying distributed earnings are taxed to the individual as a QEF Inclusion,[33] a situation that is closely comparable to the taxation of an individual's distributions from a RIC. This is illustrated by the following example.

> Example 6. On January 1, 2013, Lisa acquires stock of a PFIC as to which she makes a timely QEF election. Lisa does not make a G Election. In 2013, Lisa's share of the QEF's ordinary earnings and net capital gain are $40 and $10, respectively. The QEF distributes $10 to Lisa on December 31, 2013. For Chapter 1 purposes, Lisa has $40 of ordinary income and $10 of long-term capital gain. The Proposed Regulations could be revised to provide that, for Section 1411 purposes, the distribution is treated proportionally as a dividend and long-term capital gain according the character of the QEF's earnings out of which the distribution is made. In that case, $8 of the distribution (80%) would be treated as Category 1 Income and $2 (20%) as Category 3 Net Gain. The revision to the Proposed Regulations could provide that distributions to Lisa of her remaining share of the QEF's 2013 earnings in subsequent taxable years

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capital losses for such taxable year. Sections 851(b)(2) and 852(a). A RIC can retain some or all of its net capital gain (which is generally its realized net long-term capital gains in excess of realized net short-term capital losses), but designate the retained net capital gain as a deemed distribution to its stockholders. In that event, the RIC pays corporate-level federal income tax (at regular corporate rates) on the retained amount, but each stockholder is entitled to claim a credit against the stockholder's federal income tax liability equal to the stockholder's share of the tax paid by RIC. Section 852(b)(2)(D). As a RIC, the corporation will not pay corporate-level federal income tax on any income or gains that it timely distributes (or is deemed to distribute) to its shareholders as dividends. Section 853(b).

32 S. Rep. No. 313, 99th Cong., 2d Sess. 397 (May 29, 1986).

33 Cf. 851(b) (flush language) (treating QEF Inclusions as qualifying income of a RIC to the extent the QEF's income is distributed in the year of inclusion).

are treated proportionally as Category 1 Income and Category 3 Net Gain or, alternatively, are treated entirely as Category 1 Income.

We have considered this question and think that the Proposed Regulations should not be revised to preserve character when an individual does not make a G Election. If an individual who has made a QEF election does not make a G Election, the individual achieves deferral for Section 1411 purposes. If the individual had not made a QEF election, the individual would achieve deferral for Chapter 1 purposes, and character would not be preserved. The Congressional design of the QEF election is that the character of QEF earnings are preserved if, but only if, there is current taxation of those earnings; once taxation of those earnings is deferred, the distribution should be treated the same as a distribution from a foreign corporation that is not a QEF. We believe the results under Section 1411 should be the same. If an individual does not make a G Election, distributions from a QEF should be entirely Category 1 Income.[34] Effectively, the "toll charge" for deferral obtained by not making a G Election is a loss of the long-term capital gain character of distributed PTI from a QEF. We think this is entirely appropriate because, if an individual wants to preserve character for Section 1411 purposes, the individual has the G Election available to her.

The counter-argument is that the G Election impacts the timing of when a QEF's earnings are taxed under Section 1411. A rule regarding timing should not impact character and, thus, the Chapter 1 character of distributions from QEFs should be preserved for individuals who do not make G Elections. This counter-argument is strongest in the case of a QEF that distributes its earnings in the same taxable year in which the earnings are taxed to an individual under both Chapter 1 and Section 1411. Nevertheless, if a taxpayer wants character passthrough for PFIC gains under Chapter 1, the taxpayer must affirmatively commit to taking the QEF's earnings into the taxpayer's gross income in every year (not just in years when the QEF decides to distribute its earnings currently); we think it is fair to require an individual who wants the same character passthrough for Section 1411 purposes to commit to including the QEF's earnings in NII every year. In the absence of making a G Election, an individual should not be entitled to the same character benefit that is permitted to the individual under Chapter 1 pursuant to the Chapter 1 QEF election.

B. Double Counting of Income for Purposes of Section 1411.

1. Background. It is an established principle of the U.S. federal income tax law that the earnings and profits of a corporation are to be taxed to the corporation's shareholders only one time. This principle is reflected in Sections 301(a) and (c) and Section 316(a), which provide that a distribution of property made by a corporation to a shareholder with respect to its stock is treated as a dividend to the extent of the corporation's current or accumulated earnings and profits; and in Section 312(a) which provides that a corporation's earnings and profits are

[34] See Prop. Reg. Section 1.1411-10(c)(2)(ii) (to the extent an excess distribution within the meaning of section 1291(b) constitutes a dividend within the meaning of section 316(a), the amount is included Category 1 Income).

reduced when those earnings and profits are treated as distributed by the corporation to a stockholder.[35]

In the case of CFCs, this principle is also reflected in Section 959(a), which provides that, for Chapter 1 purposes, a distribution of a CFC's earnings and profits attributable to income previously included in the gross income of a United States shareholder as a Subpart F Inclusion is excluded from the United States shareholder's gross income (or the gross income of any other United States person that acquires any portion of such United States shareholder's CFC stock subject to the acquirer satisfying the IRS of her right to such exclusion).[36]

In the case of QEFs, the corollary to Section 959(a) is Section 1293(c), which provides that if a taxpayer establishes to the satisfaction of the IRS that a distribution by a QEF is attributable to earnings and profits that are or were included in the gross income of any United States person as a QEF Inclusion, then the distribution is excluded from the taxpayer's gross income.[37]These provisions are designed to prevent the U.S. shareholders of a CFC or QEF from being taxed more than once on the CFC's or QEF's earnings.

More than 20 years after the CFCs rules were enacted, the Code was amended to further this principle with the enactment of Section 959(e). Under Section 959(e), the amount of an individual's Section 1248 Dividend upon the disposition of stock of a CFC is treated as a Subpart F Inclusion of the individual with respect to the CFC for purposes of Section 959. Accordingly, under Section 959(a), the CFC's earnings and profits attributable to the Section 1248 Dividend are excluded from the gross income of a transferee of the individual when those earnings and profits are distributed to the transferee (subject to transferee's satisfying the IRS of the right to such exclusion);[38]

The purpose of Section 959(e) is to prevent "double counting of ordinary income…on account of the disposition of stock in a foreign corporation."[39] In explaining the background and reason for enactment of Section 959(e), the House Report states:

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35 See also Section 304(c) (in the case of an acquisition of stock to which Section 304(a) applies, the determination of the amount which is a dividend (and the source thereof) is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits); and Section 312(n)(7) (if a corporation distributes amounts in a redemption that is not treated as a Section 301 distribution, the part of such distribution which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable share of the earnings and profits of such corporation accumulated after February 28, 1913, attributable to the stock so redeemed); and Section 356(a)(2) (when an exchange described in Section 356(a)(1) has the effect of the distribution of a dividend, gain recognized by a distributee is treated as a dividend to the extent of the distributee's ratable share of the corporation's undistributed earnings and profits).

36 Section 959(d) ensures that, for purposes of Chapter 1, the distribution of PTI reduces the CFC's earning and profits.

37 Section 1293 also ensures that, for purposes of Chapter 1, the distribution of PTI reduces the QEF's earnings and profits.

38 See Rev. Rul. 90-31, 1990-1 C.B. 147, discussed below.

39 H.R. Conf. Rep. No. 98-861, 98th Cong., 2d Sess., Cong. Rec., Vol. 130, No. 87 – Part II at H6631 (June 22, 1984).

> If a U.S. person owns stock in a controlled foreign corporation and disposes of such stock at a gain to another U.S. person, the U.S. person's gain is recharacterized as dividend income in an amount equivalent to the accumulated E&P of the controlled foreign corporation, but the Internal Revenue Service took the position that such income inclusion does not reduce the E&P of the controlled foreign corporation by the amount of that income inclusion (Rev. Rul. 71-388, 1971-2 C.B. 314; cf. Rev. Rul. 83-182, 1983-51 I.R.B. (Dec. 19, 1983), suspending that ruling). That is, the taint of the previously untaxed E&P would remain even though the E&P has borne tax. A subsequent distribution by the controlled foreign corporation could therefore cause dividend treatment on account of E&P that had already caused a dividend inclusion. In addition, the new owner may take the position that it is entitled to foreign tax credits for taxes imposed on the controlled foreign corporation that the first owner (the selling corporation) has already credited. This double credit, if current law allows it, could reduce U.S. tax on other foreign income twice….The committee believes that the present law rules described above are unclear, at times possibly causing hardship in the form of a double tax and at times possibly giving taxpayers unintended benefits. The technical changes contained in the bill will clarify the operation of those rules. The committee is aware that the present rules are unclear, and intends no inference that they work as described.[40]

In Revenue Ruling 90-31,[41] the IRS described the mechanics of applying Section 959(e). In this ruling, the IRS indicated that, when a transferor shareholder recognizes a Section 1248 Dividend, under Section 959(e), an account is established on behalf of the transferee shareholder in the amount of the Section 1248 Dividend as if that amount had been included in gross income as a Subpart F Inclusion. When the foreign corporation makes a distribution to the transferee shareholder, the amount of the transferor shareholder's Section 1248 Dividend is treated as PTI that is deemed to be distributed first and, thus, is not taxed again to the transferee shareholder (subject to the transferee shareholder's satisfying the IRS that it is eligible for the Section 959(a) exclusion from gross income).[42]

In the discussion that follows, we explain why we believe that the Proposed Regulations should include rules that are analogs to Sections 959(a) and (e) and 1293(c) in order to prevent the earnings and profits of CFCs and QEFs from being taxed more than once at the shareholder-level under Section 1411. Our discussion also demonstrates that it will be important for an individual who purchases stock of a CFC or QEF from a U.S. person to obtain a significant amount of Section 1411-related information from the seller, including whether or not that person made a G Election (if an individual), the amount of the CFC's or QEF's earning and profits previously included in the seller's gross income for Chapter 1 purposes for taxable years beginning after December 31, 2012 but not yet distributed to the seller, and the amount of the seller's Section 1248 Dividend (if any) for Chapter 1 and Section 1411 purposes.

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40 H.R. Rep. 98-432, part 2, 98th Cong., 2d Sess., 1538-9 (March 5, 1984).

41 1990-1 C.B. 147.

42 The foreign corporation's earnings and profits are reduced at the time of the distribution of the PTI attributable to the Section 1248 Dividend.

2. Double Counting of Earnings Previously Taxed under a G Election. If an individual makes a G Election and subsequently transfers the CFC or QEF stock to another individual who does *not* make a G Election, it is not clear whether the transferee individual may exclude from NII a distribution of PTI that was previously included in the transferor individual's NII (as a Subpart F Inclusion or a QEF Inclusion pursuant to the G Election). If that is not the result, then a CFC's or QEF's earnings and profits could be taxed more than once to its stockholders under Section 1411 (*i.e.*, included in the NII of two different stockholders). This is illustrated by the following example:

> Example 7: On January 1, 2013, Lisa forms CFC and acquires 100% of the stock in exchange for a $100 capital contribution. Lisa makes a G Election.
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> In 2013, CFC generates $5 of subpart F income and has no other earnings and profits. CFC does not make any distributions in 2013. For Chapter 1 purposes, in 2013, Lisa has a Subpart Inclusion of $5 and this increases Lisa's tax basis in her CFC stock to $105. For Section 1411 purposes, Lisa has $5 of Category 1 Income from her investment in the stock of CFC, and her tax basis in the stock of CFC is increased to $105.
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> On January 2, 2014, Lisa sells her all of her CFC stock to Kim for $105 (and thus Lisa recognizes no gain or loss for Chapter 1 purposes or Section 1411 purposes). Kim does not make a G Election. Lisa provides to Kim information concerning her G Election, CFC's earnings and profits, the amount of Lisa's Subpart F Inclusions attributable to CFC that she included in income for purposes of Chapter 1 and Section 1411, and other information necessary for Kim to claim an exclusion from gross income under Section 959(a) for distributions from CFC attributable to PTI included in Lisa's gross income for purposes of Chapter 1.
>
> In 2014, CFC generates no earnings and profits and distributes $5 to Kim. For Chapter 1 purposes, under Section 959(a), Kim excludes the distribution from her gross income because it is attributable to PTI included in Lisa's gross income; and, under Section 959(d), the distribution reduces CFC's earnings and profits by $5 to $0. For Section 1411 purposes, it is not clear whether Kim (who has not made a G Election) is required to treat the $5 distribution as a dividend included in her Category 1 Income even though the distribution is attributable to CFC's earning previously included in Lisa's NII pursuant to Lisa's G Election.

We believe that the earnings and profits of a CFC or QEF should not be included in the NII of the CFC's or QEF's U.S. shareholders more than once. Accordingly, we recommend that the Proposed Regulations include analogs to Sections 959(a) and 1293(c). As revised, the Proposed Regulations would provide that, if a CFC's or QEF's earnings and profits are included in the NII of an individual pursuant to a G Election (whether as Category 1 Income (or, in the case of a QEF, Category 3 Net Gain)), a subsequent distribution of those earnings will be excluded from the NII of the individual's transferee (provided that the individual's transferee can establish her entitlement to the exclusion to the satisfaction of the IRS).

3. Double Counting of a CFC's Earnings Treated as a Section 1248 Dividend. If an individual sells stock of a CFC and recognizes a Section 1248 Dividend (that is included in her NII as Category 1 Income), and subsequently the CFC makes a distribution to the transferee (which for Chapter 1 purposes the distribution is treated as a non-taxable distribution of the PTI), it is not clear whether for Section 1411 purposes the distribution is similarly excluded from the transferee's NII. This is illustrated by the following example:

> Example 8. Same facts as Example 7, except Lisa does not make a G Election and she sells her CFC stock to Kim on January 2, 2014 for $105. Lisa provides to Kim information that Lisa did not make a G Election, CFC's earnings and profits, the amount of Lisa's Subpart F Inclusions attributable to CFC that she included in income for purposes of Chapter 1, the amount of Lisa's Section 1248 Dividend for purposes of Section 1411 resulting from the sale of CFC stock to Kim, and other information necessary for Kim to claim an exclusion from gross income under Section 959(a) for distributions from CFC attributable to PTI that had been included in Lisa's gross income for purposes of Chapter 1 as Subpart F Inclusions.
>
> In 2013, for Section 1411 purposes, Lisa has no NII from her investment in the stock of CFC, and her tax basis in the stock of CFC remains $100. When Lisa sells all of her CFC stock to Kim for $105 on January 2, 2014, Lisa recognizes $5 of gain for Section 1411 purposes ($105 of amount realized minus Section 1411 tax basis of $100). For purpose of Section 1411, Section 1248(a) applies to treat Lisa's $5 gain as a Section 1248 Dividend included in her Category 1 Income.[43] It is not clear under the Proposed Regulations that, Kim, who also does not make a G Election, can exclude the $5 of earnings and profits attributable to Lisa's Section 1248 Dividend for purposes of Section 1411 when those earnings and profits are distributed to Kim.

It seems clear in Example 8 that, if Kim makes a G Election, for purposes of Section 1411, the distribution to Kim in 2014 of the earnings and profits attributable to Lisa's Section 1248 Dividend would be treated as a distribution of PTI that is excluded from Kim's Category 1 Income under Section 959(a). This is because the regular rules of Chapter 1 would apply to Kim for Section 1411 purposes and the distribution would be excluded from Kim's gross income for Chapter 1 purposes under Section 959(a).[44] In Example 8, for purposes of Section 1411, Kim is treated as what is colloquially referred to as "buying" a dividend. This can occur when an individual purchases stock of a RIC shortly before the record date of a distribution. The price of the RIC's stock will include the value of the pending distribution, so that the selling individual will recognize capital gain (which could be long-term capital gain) attributable to the RIC's earnings to be distributed, and the buying individual will be taxed on the distribution when she receives it (at ordinary rates to the extent the distribution is treated as an

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[43] Because Lisa did not make a G Election, the Subpart F Inclusion included in Lisa's gross income for Chapter 1 purposes in 2013 is not excluded from CFC's earnings and profits in applying Section 1248(a) for purposes of computing Lisa's Section 1411 consequences in 2014. Prop. Reg. Section 1.1411-10(c)(4)(ii).

[44] Prop. Reg. Section 1.1411-10(c)(2) applies to an individual only if the individual does not make a G Election. Under Prop. Reg. Section 1.1411-1(a), except as otherwise provided, all Code provisions that apply for purposes of Chapter 1 in determining taxable income of an individual also apply in determining the tax imposed on the individual under Section 1411.

ordinary dividend) even though economically the distribution represents a return of her investment in the RIC's stock.[45]

In the case of the CFC rules, Section 1248 prevents an individual from accumulating earnings tax-free in a non-U.S. corporation and effectively repatriating those earnings at capital gains rates by selling the stock of the CFC. There is no analog to Sections 1248(a) or Section 959(e) in the RIC rules (or the QEF rules) because, as discussed above, the RIC rules (and the QEF rules) already operate to prevent tax-free accumulation of earnings in a domestic corporation (or a QEF) and their repatriation at capital gains rates. Although an individual shareholder in a RIC can "buy" a dividend, the individual selling shareholder is taxed on the gain attributable to the dividend at capital gains rates – the selling shareholder is not treated as receiving any sort of deemed dividend of the RIC's earnings (and the RIC's undistributed earnings and profits are not reduced by the gain recognized by the selling shareholders). An individual can avoid this consequence by timing her purchase of RIC stock until after the ex-dividend date. By contrast, gain treated as a Section 1248 Dividend is taxed to the individual selling shareholder at ordinary income rates regardless of the timing of the sale, because it is recharacterized as a deemed repatriation of the CFC's undistributed earnings and profits to the individual selling shareholder (and when actually distributed to the transferee, those earnings and profits are not taxed again to that transferee but do reduce the CFC's earnings and profits). Accordingly, the fact that in the case of a RIC an individual can be taxed on a distribution that the individual has essentially just paid for does not support putting an individual in that same place for Section 1411 purposes when buying stock of a CFC.

We believe that the rationale for the enactment of Section 959(e) and the IRS' position in Revenue Ruling 90-31 apply equally to Section 1411; that is, we believe that earnings of a CFC should not be taxed more than once to its U.S. shareholders under Section 1411. The earnings of a foreign corporation that is not a CFC or QEF would not be taxed more than once to its shareholders under Section 1411 when they are distributed. Accordingly, we recommend that the Proposed Regulations include an analog to Section 959(e). As revised, the Proposed Regulations would provide that, when a foreign corporation's earnings and profits attributable to a Section 1248 Dividend of an individual are distributed to the individual's transferee, the distribution is excluded from the Category 1 Income of the transferee (subject to the transferee satisfying the IRS of her entitlement to the exclusion).

To summarize, for the reasons set out in Parts B.2. and this Part B.3., we recommend that the Proposed Regulations include analogs to Sections 959(a) and (e) and 1293(c) to prevent the earnings and profits of CFCs and QEFs from being taxed more than once to their U.S. shareholders under Section 1411.

C. <u>Treatment of Transferee When Transferor Does Not Make a G Election and the Potential for CFC Earnings to Never Be Included in Category 1 Income for Purposes of Section 1411</u>. It appears that, under some circumstances, a CFC's or QEF's earning and profits escapes taxation as Category 1 Income under Section 1411. This is illustrated by the following example.

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[45] See Reg. Section 1.61-9(c).

Example 9. On January 1, 2013, Lisa forms CFC and acquires 100% of the stock of CFC in exchange for a $100 capital contribution. CFC invests the $100 capital contribution in an investment portfolio. Lisa does not make a G Election.

In 2013, CFC generates $5 of subpart F income and has no other earnings and profits. CFC does not make any distributions in 2013. For Chapter 1 purposes, in 2013, Lisa has a Subpart Inclusion of $5 and this increases Lisa's tax basis in her CFC stock to $105. In 2013, for Section 1411 purposes, Lisa has no NII from her investment in the stock of CFC, and her tax basis in the stock of CFC remains at $100.

At the end of 2013, CFC holds investments with a value of $95 (and a tax basis of $100) and cash of $5 (the investments generated cash and also decreased in value).

On January 2, 2014, Lisa sells her all of her CFC stock to Kim for $100. For Chapter 1 purposes, Lisa recognizes a long-term capital loss ($100 of amount realized minus Chapter 1 tax basis of $105). For Section 1411 purposes, Lisa recognizes no gain or loss.

Kim makes a G Election.[46]

In 2014, CFC generates no earnings and profits and distributes $5 to Kim. For Chapter 1 purposes, under Section 959(a), Kim excludes the distribution from her gross income because it is attributable to PTI that had been included in Lisa's gross income as a Subpart F Inclusion and, under Section 959(d), the $5 distribution is not treated as a dividend, but the distribution reduces CFC's earnings and profits by $5 to zero. Under the Proposed Regulations, the $5 distribution is not included in Kim's Category 1 Income because she made a G Election and, thus, Kim's Section 959(a) exclusion for Chapter 1 purposes also applies to her for Section 1411 purposes. For Chapter 1 and Section 1411 purposes, Kim's tax basis in her CFC stock is (pursuant to Section 961(b)) reduced by $5 from $100 to $95.

By the end of 2014, CFC's investment portfolio has recovered in value (*i.e.*, it is now worth $100). On December 31, 2014, Kim sells all of the stock of CFC to Diana for $100. For Chapter 1 purposes, Kim recognizes $5 of long-term capital gain ($100 of amount realized minus tax basis of $95). Because CFC's earnings and profits are zero at the end of 2014 for Chapter 1 purposes, none of Kim's gain is recharacterized as a Section 1248 Dividend for Chapter 1 purposes. Because Kim made a G Election, her Section 1411 consequences follow her Chapter 1 consequences and, consequently, for Section 1411 purposes, Kim recognizes $5 of Category 3 Net Gain.

[46] Lisa provides to Kim information that she did not make a G Election, CFC's earnings and profits, the amount of Lisa's Subpart F Inclusions attributable to CFC, the amount of her loss on the sale of CFC stock for purposes of Chapter 1, and other information necessary for Kim to claim an exclusion from gross income under Section 959(a) for distributions from CFC attributable to PTI that had been included in Lisa's gross income for purposes of Chapter 1 as a Subpart F Inclusion.

First, we address why we believe that the consequences to Kim set out above are correct. Under Section 1248(d)(1), a foreign corporation's undistributed earnings and profits attributable to Subpart F Inclusions included in the gross income of a United States person with respect to the stock that is sold are excluded from the foreign corporation's earnings and profits with respect to such United States person for purposes of applying Section 1248(a) to that person's sale. Prop. Reg. Section 1.1411-10(c)(4) provides that, "[i]f no election is made pursuant to paragraph (g) of this section, for purposes of section 1411 and §1.1411-4:…Section 1248(a) applies without regard to the exclusion for certain earnings and profits under Section 1248(d)(1)…" This means that, when individual does not make a G Election, the undistributed earnings of a CFC attributable to Subpart F Inclusions included in gross income under Chapter 1 in a taxable year beginning after December 31, 2012 are not excluded from the CFC's earnings and profits in determining the consequences under Section 1248(a) for Section 1411 purposes. We understand the reference in Prop. Reg. Section 1.1411-10(c)(4) to no G Election being made as referring to the individual whose consequences are being determined.[47] Therefore, we interpret the rule in Prop. Reg. Section 1.1411-10(c)(4) as not applying to determining the NII "category" of Kim's gain from her sale of the CFC stock in 2014 because Kim makes a G Election.

If the rule in Prop. Reg. 1.1411-10(c)(4) were to apply to Kim, then her $5 of gain from the sale of CFC stock would be recharacterized as a Section 1248 Dividend included in her Category 1 Income for Section 1411 purposes instead of her Category 3 Net Gain. We believe that this would not be appropriate because, in making a G Election, Kim has given up the deferral she otherwise would have had for Section 1411 purposes. Having done that, we do not believe that it is equitable that Kim should have to apply the non-G Election Section 1411 rules because Lisa (the prior owner) did not make a G Election.

We suggest that the Proposed Regulations be revised to include an example that illustrates how this rule works and clarifies the result in a fact pattern like this one.

The second issue raised by Example 9 is that CFC's $5 of earnings and profits from 2013 were never included in any individual's Category 1 Income under Section 1411, and it appears that they never will be.[48] We do not see this as a problem with the Proposed Regulations. The $5 of CFC's earnings did not escape Section 1411 taxation. When Kim sold the stock in 2014, Kim recognized $5 of gain. If Kim had not made the G Election, this $5 would have been included in Kim's NII as $5 of Category 1 Income (pursuant to Section 1248). By contrast, because Kim did make the G Election, the $5 was included in NII as Category 3 Net Gain. Under both scenarios, the $5 is included in NII and going forward the $5 is no longer treated as undistributed earnings (either for Chapter 1 or Chapter 2A purposes). There seems to be no

[47] In this regard, throughout the Proposed Regulations, the phrase "if no election is made pursuant to paragraph (g) of this section" is used, and it would be helpful for this language to be clarified by stating "if the taxpayer does not make an election pursuant to paragraph (g) of the section."

[48] The reasoning behind this is as follows. In the case of a shareholder that makes a G Election, the earnings and profits will be treated as having been distributed to such shareholder. In the case of a shareholder that does not make a G Election, one would need to construct what has happened under Section 1411 (in a non-G Election world). This analysis would be that, if Kim had not made a G Election, the earnings and profits would have been deemed distributed to her in 2014 under Section 1411 (pursuant to Section 1248) and therefore, under the Section 1411 non-G Election view of what has happened, those earnings have been distributed.

reason why the inclusions of the $5 in Category 3 Net Gain instead of Category 1 Income is problematic; and, if it is problematic, it is not a problem that should be addressed by disadvantaging Kim, for the reasons set out above.

D. Earnings Taxed to Different Individuals under Chapter 1 and Section 1411. It appears that, under some circumstances, a CFC's earnings and profits for a year will be taxed to different individuals under Chapter 1 and Section 1411. This is illustrated by the following example.

> Example 10. Same facts as Example 9, except that Kim does not make a G Election.
>
> In 2014, when CFC distributes the $5 to Kim, for Chapter 1 purposes Kim excludes the distribution from her gross income (because it is attributable to PTI included in Lisa's gross income).
>
> For Section 1411 purposes, the $5 distribution is included in Kim's Category 1 Income (because for Section 1411 purposes CFC had $5 of undistributed earnings and profits from 2013).

In Example 10 (as in the case of Example 9), CFC has $5 of undistributed earnings and profits from 2013 for Section 1411 purposes. The $5 of earnings was included in Lisa's Chapter 1 income and is included in Kim's Chapter 2A income. (We note that if Lisa had sold her stock for a gain of at least $5, then the earnings would have been deemed distributed to her for Section 1411 purposes, pursuant to Section 1248.) In Example 10, Kim is essentially in the same position as someone who buys RIC stock right before a dividend is paid. Kim is "buying" a dividend for Section 1411 purposes. We believe that this is the proper result under the structure of the Proposed Regulations. Presumably, buyers and sellers will address this type of situation through an adjustment to the price of CFC stock or by negotiating for pre-sale distributions of the CFC's earnings and profits not previously taxed under a G Election.

E. Retroactive G Elections and Cleansing G Elections. In this section we discuss why we recommend that the rules governing the making of untimely G Elections follow the rules governing the making of untimely QEF Elections.

1. Retroactive G Election. Under certain circumstances, a direct or indirect shareholder of a PFIC is permitted to make a retroactive election to treat the PFIC as a QEF.[49] We recommend that an individual who makes a retroactive QEF election and has not previously made a G Election be permitted to make an accompanying retroactive G Election.

The PFIC regulations provide three types of retroactive QEF elections: (i) where the shareholder filed a protective statement and a reasonable belief statement with her initial return for the year, (ii) where the shareholder is a "qualified shareholder" (meaning that generally she owns less than 2% of each class of stock and relied upon a statement made by the foreign corporation that it thought it was not a PFIC), and (iii) where special consent is granted by the

[49] Reg. Section 1.1295-3.

Commissioner.[50] Each has safeguards built into it to ensure that the shareholder had a reason for not making the QEF election on a timely basis (that the government views as an appropriate excuse) and that generally the government will not be prejudiced as a result of the election not having been made on a timely basis. The PFIC regulations make these the exclusive methods of making a retroactive QEF (by explicitly providing that relief under Reg. Section 301.9100 is not available).[51]

Under the Proposed Regulations, an individual who fails to make a timely G Election has only one option, which is a request to make a retroactive election under Reg. Section 301.9100. We recommend that the Section 1411 regulations follow the retroactive QEF election rules by explicitly providing that no Reg. Section 301.9100 relief will be available to request the right to make a late G Election and explicitly providing for relief that correlates to the three QEF retroactive election methods. If the individual has met the requirements that Treasury and the IRS have established for qualifying to make a retroactive QEF election, we see no reason why that individual should not also be considered eligible to make a retroactive G Election at the same time.

We recommend that in the case of the protective statement retroactive election, that the PFIC regulations (and the Proposed Regulations) be revised to provide that the shareholder may apply the same rules to making a retroactive G Election provided that the protective statement specify that the shareholder is making a protective G Election along with the protective QEF Election.

In the case of the qualified shareholder retroactive election, we think that if the shareholder meets the requirements to be a qualified shareholder, the shareholder should be permitted to make a retroactive G Election at the same time as the shareholder makes a retroactive QEF election.

In the case of the special consent retroactive election, we think that the shareholder should be entitled to make a retroactive G Election under the same rules that apply to a retroactive QEF under Treas. Regs. 1.1295-3(f), including paragraph (f)(3)(ii).

2. <u>Cleansing G Elections</u>. Under the PFIC regulations, a shareholder who is not eligible to make a retroactive QEF election may achieve similar results by making a QEF election for the current year and a deemed dividend election under Treas. Reg. 1.1291-9 or a deemed sale election under Treas. Reg. 1.1291-10. The QEF election turns the PFIC into a QEF for the current year and all future years; the deemed dividend and deemed sale elections (each, a "<u>PFIC Cleansing Election</u>") "purge" the non-QEF taint from the shares by imposing an additional tax (the "<u>Additional Tax</u>") on the shareholder to reflect *both* the income taxes she would have paid if the PFIC had been a QEF in each of those prior years (and each year's QEF Inclusion had been included in gross income in that year) *and* the amount of late payment interest she would have paid had those payments been initially due with the earlier years' returns (but not paid until the date of the elections).[52] The PFIC Cleansing Elections operate not by including the prior year's

[50] *Id*.

[51] Reg. Section 1.1295-3(a).

[52] *See* Section 1291 and Reg. Sections 1.1291-9 and 1.1291-10.

QEF Inclusions in the gross income, but rather adding to the total taxes due an amount equal to the Additional Tax. Among other things, this ensures that the QEF Inclusions are subject to income tax and that the shareholder is not obtaining an advantage by making the election late.

a. Individual Who Makes a PFIC Cleansing Election. We recommend that the regulations permit an individual who makes a PFIC Cleansing Election to make an accompanying "cleansing" G Election (what we will call a "G Cleansing Election"). The G Cleansing Election could piggyback the consequences of the PFIC Cleansing Election, with the taxpayer being required to pay an amount of additional Section 1411 tax equal to the Section 1411 tax that would have been due if the PFIC had been a QEF and a G Election were in effect in each of those prior years (and each year's QEF Inclusion had been included in NII in that year[53]) *and* the amount of late payment interest she would have paid had those payments been initially due with the earlier years' returns (but not paid until the date of the elections).[54] Thus, like the PFIC Cleansing Election, the prior year's QEF Inclusions would not be included in NII. This would incorporate into the Section 1411 rules the same safeguards that are built into the PFIC Cleansing Election regime in terms of ensuring that the Section 1411 tax is paid and that the individual does not benefit from making the G Election late.

b. Individual Who Makes a QEF Election but not a G Election and Subsequently Wants to Cleanse the Non-G Taint From the QEF Shares. Should the Section 1411 regulations also allow a shareholder to make a G Cleansing Election when the shareholder is not simultaneously making a PFIC Cleansing Election (in other words, the QEF Election was made in a prior year)?[55] In other words, should a shareholder of a QEF, who was thus eligible to make a G Election but did not, have another option available in addition to the three types of retroactive G Elections we recommend (in Section E.1.) be made available? Yes, would mean that the individual would have the same options that a PFIC shareholder who did not make a QEF election has, and no would mean that the individual has one less option than the shareholder of a PFIC has.

An individual who is eligible to make a G Election (*i.e.*, she holds QEF stock) may knowingly chose to not make a G Election in order to benefit from the deferral of the Section 1411 tax on Subpart F Inclusions and QEF Inclusions. Such an individual may regret that decision, however, because of the resulting costs of the complexities of computing income and gain from investments in CFCs and QEFs on two different bases (one for purposes of Chapter 1 and another for Section 1411 purposes). Such an individual may, in connection with a potential sale of the stock to another U.S. individual, wish to "cleanse" the CFC or QEF of earnings that been taxed under Chapter 1 but not been taxed under Section 1411. It is also quite possible that an individual will fail to make a G Election due to lack of knowledge or poor advice. Such an individual may be willing to forego pursuing a retroactive G Election under one of the three retroactive G methods and instead take the more certain and less administratively

53 Taking into account only years during which Section 1411 was in effect and applied to the taxpayer.

54 *See* Section 1291 and Reg. Sections 1.1291-9 and 1.1291-10.

55 This G Cleansing Election would be available only for years during which the PFIC was a QEF (i.e., if the PFIC is an unpedigreed QEF, no G Cleansing Election should be permitted for years preceding the effective date of the QEF election).

burdensome route of simply paying the additional taxes that would be due upon making a G Cleansing Election.

We believe that the hypothetical individuals described in the prior paragraph should be permitted to make a G Cleansing Election, for the same reason that Section 1291 permits a PFIC shareholder to make a PFIC Cleansing Election. The government is not prejudiced because the government collects the full amount of taxes with interest to account for the time value of money and, given the complexity of these regimes, taxpayers should not be denied the opportunity to "make it right" in this way. Accordingly, we recommend that the G Cleansing Election be made available to a QEF shareholder (who is not making a simultaneous PFIC Cleansing Election).

F. Partnerships and S Corporations That Hold CFC or PFIC Stock.

1. G Elections at the Entity Level. For the reasons discussed in this section, we recommend that S corporations and domestic partnerships[56] that hold CFC or QEF stock be permitted to make G Elections at the entity level.

The G Election paradigm is quite complex when the CFC or PFIC stock is not held by the individual directly but is instead held through an S corporation or domestic partnership. If all of the shareholders and direct and indirect partners who are individuals make G Elections, the S corporation or domestic partnership can apply Section 1411 at the entity level without making any of the special adjustments described above. If, however, even a single individual shareholder or direct or indirect partner does not make a G Election, the S corporation or domestic partnership is presumably required to track both the Chapter 1 computations of undistributed earnings and profits, PTI, basis, et cetera, and also the Section 1411 computations of those amounts. Each year, the S corporation or domestic partnership would need to compute the Section 1411 amounts for the owners who had not made the G Election and the Section 1411 amounts for the owners who had made the G Election. Presumably, the S corporation or domestic partnership would be obligated to report all these amounts on the S corporation and domestic partnership returns filed with the IRS and the individual Schedule K-1s given to the shareholders and partners. (If the partnership that has a Section 754 election in effect, this becomes even more complicated.)[57]

Even if all of the current shareholders and direct partners have made G Elections, the S corporation or domestic partnership will presumably still need to maintain Section 1411 non-G computations because a shareholder or direct partner might sell to a transferee who does not make a G Election. In addition, domestic partnerships will need to determine on a continuous basis whether they have indirect partners who are individuals, trusts or estates potentially subject to Section 1411 so that the necessary information can be provided to the entities through which the indirect partners hold their interests. It may be difficult (if not impossible in some cases, such

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56 We are limiting this discussion to domestic partnerships because generally the reporting regime for foreign partnerships does not obligate the foreign partnership to report information to its partners in the same way as a domestic partnership is required to.

57 A partner or S corporation shareholder who does not make a G Election will also need to track her basis in her S corporation stock or her direct or indirect basis in her partnership interest for both Chapter 1 and Section 1411 purposes.

as when a partner is a funds-of-funds) for partnerships to obtain this information. Consequently, in practice, any domestic partnership that has a passthrough entity as a partner, or that could in the future have a direct or indirect partner who is subject to Section 1411, will likely have to track and report these items for Section 1411 purposes (even if the entity currently has no direct or indirect partner who is subject to Section 1411 and has not made a G Election).[58]

Presumably, an S corporation or domestic partnership could address these problems by contractually obligating all its owners to make the G Election.[59] But, this would potentially be problematic for S corporations and partnerships that are already in existence and could become a bargaining point in setting up S corporations and partnerships going forward and in our view that would give this tax issue an inappropriate role in the business negotiations between the owners.[60]

We believe that it would be more appropriate and reasonable for regulations to provide that S corporations and domestic partnerships are permitted to make G Elections at the entity level and that those elections would bind their respective shareholders and direct and indirect partners with respect to income and gain derived from an electing S corporation's or domestic partnership's investments in CFCs and QEFs. In addition, no G Election made by a shareholder or direct or indirect partner would apply to CFC or QEF stock held through an S corporation or partnership (that is, the only election that could apply to that stock would be one made by the entity).

We also recommend an anti-abuse component. As mentioned above, an individual's G Election applies to all of the individual's interests in CFCs and PFICs (the "consistency requirement") and cannot be revoked without the consent of the IRS. To avoid individuals from using domestic partnerships and S corporations to "cherry pick" which CFCs or PFICs as to which they make G Elections, we would recommend an anti-abuse rule. One option would be to provide as follows:

- an S corporation's or partnership's G Election will not be respected if the S corporation or partnership was formed or availed of with a principal purpose of facilitating avoidance of the consistency requirement; and

- a Section 708(b)(1)(B) termination would cause a partnership's G Election to terminate, and the "new" partnership would be entitled to make a G Election even if the "old" partnership had not, unless a principal purpose of the transaction resulting in the termination was to revoke the G Election of the old partnership without the consent of the IRS or to make a G for the new partnership (in which case, the old

58 The Proposed Regulations do not address the extent of the obligations that S corporations and partnerships would have with respect to providing this information to their shareholders and partners.

59 Query what the entity's tax reporting obligations would be if there were such a contractual obligation and the entity became aware, prior to filing its return, that a shareholder or partner had breached the agreement and not made a G Election.

60 To further complicate this, the contractual obligation would be effective only if it obligated all partners that are themselves passthrough entities to have comparable contractual obligations with their owners. In the case of pre-existing partnerships and S corporations, it could very difficult for them to ensure that the G Election was made all the way up the chain of indirect owners.

partnership's G Election or lack of a G Election would carry over to the new partnership).[61] There could be a rebuttable presumption of such a principal purpose when the old partnership and the new partnership are more than 50% owned by the same individuals, directly or indirectly, applying the rules of constructive ownership under Section 267(c) other than Section 267(c)(3).

Finally, in the event any PFIC or CFC stock subject to a G Election is distributed from, or contributed to, an S corporation or partnership, a pre-existing G Election should continue to apply to the stock. In the case of a contribution, there could be a rule like Section 704(c) that continues the G Election as to only the contributor, or the G Election could be treated as applying with respect to all the owners.[62]

2. The Impact of Section 751. Section 751 is intended to create a similarity between the tax results that apply when a partner sells an interest in a partnership and when the partnership sells it assets and then allocates the ordinary income to the individual. In the Section 1411 context where the partnership holds CFC stock subject to Section 1248, Section 751 appears to instead create a divergence in results.

Under the Proposed Regulations, if an individual sells stock of a CFC directly, all or a portion of the individual's gain treated as a Section 1248 Dividend is included in the individual's Category 1 Income; and if, a domestic partnership sells stock of a CFC directly, all or a portion of the gain will be treated as a Section 1248 Dividend, which will be included in an individual partner's Category 1 Income. When an individual is a partner in a foreign partnership that sells stock of a CFC, for purposes of Section 1248, the individual will be treated as selling his proportionate share of the stock of the CFC,[63] and a Section 1248 Dividend recognized by the individual will be included in his Category 1 Income. So, all three of these scenarios have the same Section 1248 Dividend/Category 1 Income results for the individual.

If, instead, the individual sells the interest in the partnership, the amount of the gain that is a Section 1248 Dividend does not go into Category 1 Income. This is because of Section 751. Specifically, a sale of a partnership interest gives rise to gain or loss that would normally be included in Category 3 Net Gain (subject to the partnership interest not being an asset of a Section 1411 Business). When a U.S. individual sells an interest in a domestic or foreign partnership where that partnership holds CFC stock to which Section 1248 would apply if the stock were sold by the partnership, Section 751(c) recharacterizes the gain up to the amount of the Section 1248 Dividend that would be recognized by the individual as ordinary income.[64]

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61 See McKee, Nelson & Whitmire, Federal Taxation of Partnerships & Partners (WG&L), ¶ 13.01 ("The §708(b)(1)(B) rules are almost entirely mechanical. Consequently, [they are] rather easily manipulated by sophisticated taxpayers who are interested in avoiding terminations or in creating them.").

62 If an individual who held non-G Election stock contributed the stock to a partnership or S corporation that made or makes a G Election, the S corporation or partnership would presumably be obligated to maintain a complicated set of Section 704(c)-like accounts for the pre-G Election period during which the shareholder or partner held the stock.

63 Treas. Reg. Section 1.1248-1(a)(4) and (a)(5), Example 4.

64 See Treas. Reg. Section 1.751-1(c)(4)(iv)(an unrealized receivable includes potential gain from stock in a foreign corporation described in Section 1248; the potential gain is the amount that would be treated as gain

But, Section 751(c) does not treat this ordinary income as a dividend, and we have found no authority that treats this income *as a dividend* for any purpose (including that it is not treated as "qualified dividend income" under Section 1 and does not result in a reduction to the related CFC's earnings and profits). Moreover, Section 1248(g) provides that Section 1248 does not apply to ordinary income so Section 1248 itself does not treat Section 751(c) ordinary income as a dividend. Thus, even though Section 751 treats the Section 1248 Dividend amount as a "hot asset" (and thus as giving rise to ordinary income), it does not mimic the results that would have occurred had the individual partner sold the stock directly (which, as noted above, is the purpose of Section 751).

Accordingly, it appears that the portion of an individual's gain from the sale of a partnership interest that is treated as ordinary income under Section 751(c) is not included in the individual's Category 1 Income. Rather, this gain remains in Category 3 Net Gain. This is illustrated by the following example:

> <u>Example 11(a)</u>. On January 1, 2013, Lisa and Diana form domestic Partnership by each contributing $50 to Partnership for a 50% interest. Partnership forms CFC and owns 100% of the stock of CFC acquired for a $100 capital contribution. Lisa makes a G Election and Diana does not make a G Election. In 2013, CFC generates $12 of subpart F income (and no other earnings and profits) and makes no distributions. Partnership has no other partnership income or assets in 2013 and makes no distributions.
>
> On January 2, 2014, Diana sells her entire interest in Partnership for $80 to Kim. Focusing the consequences relating to Diana, for Chapter 1 purposes, in 2013, Diana's distributive share of Partnership income is $6, and she increases her basis in her partnership interest by $6 to $56. For Section 1411 purposes, in 2013, Diana has no NII and her basis in her partnership interest remains at $50. For Chapter 1 purposes, Diana's gain from the sale of her partnership interest is $24 ($80 of amount realized minus Chapter 1 tax basis of $56). All of the Diana's gain is treated as long-term capital gain. For Section 1411 purposes, Diana's gain is $30 ($80 of amount realized minus Section 1411 tax basis of $50). $6 of this gain should be treated as an unrealized receivable under Section 751(c). Because Section 751(c) treats this gain as ordinary income, rather than as a dividend, the $6 of gain is not included in Diana's Category 1 Income. Rather, the entire $30 of Diana's gain is included in her Category 3 Net Gain.
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> <u>Example 11(b)</u>. Assume the same facts as Example 12(a), except that each of Lisa and Diana acquire the stock of CFC directly (rather than through Partnership) in exchange for a $50 capital contribution to CFC, and that Diana sells all of her CFC stock to Kim on January 2, 2014 for $80. In 2013, for Chapter 1 purposes, Diana's has a Subpart F Inclusion of $6 and her tax basis in CFC stock increases by $6 from $50 to $56. For Section 1411 purposes, Diana has no NII and her tax basis in CFC stock remains at $50. For Chapter 1 purposes, Diana's gain from the sale of her CFC stock is $24

described in Section 1248 if, at the time of the relevant transaction, the stock were sold by the partnership at its fair market value).

(amount realized of $80 minus Chapter 1 tax basis of $56), and the gain is entirely long-term capital gain. For Section 1411 purposes, Diana's gain from the sale of her CFC stock is $30 (amount realized of $80 minus Section 1411 tax basis of $50). Under Section 1248 as applied for Section 1411 purposes, $6 of Diana's gain is treated as a Section 1248 Dividend included in her Category 1 Income. The remaining $24 of her gain is included in her Category 3 Net Gain.

Thus, it appears that, if the individual sells the CFC stock or the partnership sells the CFC stock, the Section 1248 Dividend is included in the individual's Category 1 Income, but if the individual sells the partnership interest, that amount is included in Category 3 Net Gain.[65] We note that the amount will be ordinary income and thus will not be permitted to be offset by long-term capital losses that are included in Category 3 Net Gain, and that properly allocable deductions will be available to offset the income in the same manner as if it were included in Category 1 Income. However, the placement of the amount in Category 3 Net Gain does mean that some items in Category 3 Net Gain could be used to offset the amount which would not be available to offset the amount if it were instead in Category 1 Income.

Thus, the computation of an individual's NII may differ depending upon whether the individual sells an interest in a domestic or foreign partnership that holds stock of a CFC, whether the domestic or foreign partnership sells the stock of the CFC itself or whether the individuals holds and sells the CFC stock directly. We note that such difference in computation could result in well-advised taxpayers structuring their holdings of stock of a CFC through a domestic or foreign partnership and disposing of their interests in the CFC by disposing of their interests in the partnership in order to minimize their NII, although the effectiveness of this strategy may be limited by the fact that most of the losses in Category 3 Net Gain are likely to be capital losses. We would like to recommend that the Section 751(c) amount corresponding to the Section 1248 Dividend be treated as Category 1 Income, but it is unclear if this would be inconsistent with prior interpretations of Section 751 and perhaps beyond Treasury and the IRS' authority.

We do recommend that the regulations contain an example illustrating the operation of Section 751 when a partner sells an interest in a partnership that holds CFC stock. The results are so non-intuitive that the clarity would be helpful.

IV. Authority.

Our primary recommendation is that Treasury and the IRS issue regulations that treat Subpart F Inclusions and QEF Inclusions as currently includible in NII as dividends that are included in Category 1 Income (or, in the case of long-term capital gain QEF Inclusions, as capital gain that is included in Category 3 Net Gain). In the Preamble to the Proposed Regulations, Treasury and the IRS express the view that Subpart F Inclusions and QEF Inclusions cannot be treated as dividends for U.S. federal tax purposes in the absence of a provision of the Code specifying that they are so treated. The Preamble cites Rodriguez v.

[65] We note that treating this Section 751(c) ordinary income as income in Category 3 Net Gain is consistent with the Treasury Department's and IRS' view that an item of income cannot be treated as a dividend for any federal tax purposes in the absence of a specific Code provision providing for such dividend treatment.

Comm'r, 137 T.C. 174 (2011) (hereinafter, "Rodriquez"), in support of this view with respect to Subpart F Inclusions.

> Under subpart F of the Code, a United States shareholder (as defined in section 951(b)) of a CFC is required to include certain amounts in income currently under section 951(a) (section 951 inclusions). Section 951 inclusions are not treated as dividends unless expressly provided for in the Code, and therefore are not within any of the categories of income items that comprise net investment income (unless the amount is derived from a trade or business to which the tax applies as provided in section 1411(c)(1)(A)(ii) and proposed § 1.1411-4(a)(1)(ii)). See Rodriguez v. Comm'r, 137 T.C. 174 (2011). Similarly, a United States person owning shares in a PFIC also is required to include amounts in income currently under section 1293(a) (section 1293 inclusions) if the person makes a qualified electing fund (QEF) election under section 1295 with respect to the PFIC. Section 1293 inclusions also are not treated as dividends unless expressly provided for in the Code, and, therefore, also are not taken into account for purposes of calculating net investment income (unless the amount is derived from a trade or business to which the tax applies as provided in section 1411(c)(1)(A)(ii) and proposed §1.1411-4(a)(1)(ii)).

We believe that Treasury and the IRS do have authority to issue regulations that treat Subpart F Inclusions and QEF Inclusions as currently includible in NII for Section 1411 purposes, and we urge Treasury and the IRS to do so.

The determination of whether Treasury and the IRS have this regulatory authority is governed by Mayo Foundation for Medical Education & Research, Et. Al. v. U.S., 131 S.Ct. 704 (2011), which applied the two-part inquiry of Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) (hereinafter "Chevron"). The first part of the inquiry asks whether Congress has "directly addressed the precise question at issue."[66] If the answer is "yes," then the regulations must follow "the unambiguously expressed intent of Congress."[67] If the answer is "no," then the analysis proceeds to the second part of the inquiry which asks whether the administrative interpretation at issue is a "permissible construction of the statute".[68]

Addressing the first part of the inquiry, neither the text of Section 1411 nor its legislative history[69] addresses whether Subpart F Inclusions and QEF Inclusions are intended to be included in NII as "dividends" or what the word "dividend" means when used in Section 1411. Accordingly, Congress has not directly addressed the question and we believe that the term "dividend" in Section 1411 is ambiguous as to whether it includes Subpart F Inclusions and QEF Inclusions.

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66 Chevron at 842-3.

67 Id.

68 Chevron at 843.

69 We are not commenting on whether the Joint Committee reports are "legislative history".

We do not believe that Rodriquez compels a different answer to this first question. Rodriguez held that income inclusions under Section 956 are not "qualified dividend income" for purposes of Section 1(h)(11). The Tax Court was quite clearly addressing the narrow question of the meaning of "dividend" in the context of Section 1(h)(11). In its analysis, the Tax Court concluded that "section 951 inclusions are not to be treated as dividends absent express provision in the Code *or the regulations* (emphasis added)".[70] The Tax Court noted that there were indications in the legislative history and the construction of Section 1(h)(11) that Congress did not intend for Subpart F Inclusions to be treated as qualified dividend income,[71] and that post-enactment the Joint Committee on Taxation cited "with apparent approval"[72] the IRS guidance in Notice 2004-70, which stated that Subpart F Inclusions cannot constitute qualified dividend income. Therefore, we do not believe that the holding or analysis in Rodriquez clarifies Congress' intent in using the word "dividend" in Section 1411.

Addressing the second part of the Chevron inquiry, we believe that a regulation interpreting the word "dividend" as used in Section 1411 to include Subpart F Inclusions and QEF Inclusions would be a reasonable interpretation of Section 1411. We also believe it would be reasonable to interpret "net gain" as used in Section 1411 to include long-term capital gain QEF Inclusions.

There is no indication that, when Congress used the word "dividend" in Section 1411, Congress intended to exclude from NII deemed distributions of a foreign corporation's earning

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70 137 T.C. at 178.

71 The Tax Court stated that:

> According to its legislative history, section 1(h)(11) was intended in part to remove a perceived disincentive for corporations to pay out earnings as dividends instead of retaining and reinvesting them. Because income inclusions under section 951(a)(1)(B) represent earnings that CFCs have retained and reinvested in U.S. property instead of paying them out as dividends, characterizing these amounts as qualified dividend income would not appear to further the stated legislative purpose (footnote omitted).
>
> Further evidencing an absence of legislative purpose to treat section 951 inclusions as qualified dividend income, certain technical rules of section 1(h)(11) are a poor fit for section 951 inclusions. For instance, section 1(h)(11)(B)(iii), in coordination with section 246(c), imposes upon the taxpayer a holding period requirement with respect to the stock on which dividends are paid. This holding period is based on the shareholder's ex-dividend date. See sec. 246(c)(1). Because a section 951 inclusion implicates no declaration or payment of a dividend, there is no ex-dividend date by which to measure the holding period.

The legislative history the Tax Court was referring to stated that:

> In addition, the Committee finds that present law, by taxing dividend income at a higher rate than income from capital gains, encourages corporations to retain earnings rather than to distribute them as taxable dividends. If dividends are discouraged, shareholders may prefer that corporate management retain and reinvest earnings rather than pay out dividends, even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings. This is another source of inefficiency as the opportunity to earn higher pre-tax returns is bypassed in favor of lower pre-tax returns. [H. Rept. 108-94, at 31 (2003), 2003-3 C.B. 35, 65.]

72 137 T.C. at 182, n.12.

and profits that are taxed on a current basis under Chapter 1 in the same manner as actual dividends. There is no indication that Congress intended the use of the word "dividend" to create a difference in timing of items of income as between Chapter 1 and Section 1411. We think interpreting the term "dividend" to include Subpart F Inclusions and QEF Inclusions in this context is clearly reasonably.

We also believe that this interpretation is more appropriate than the interpretation reflected in the Proposed Regulations where distributions of PTI that are not included in gross income under Chapter 1 are treated as dividends includible in NII and where "adjusted gross income" is modified to back out Subpart F Inclusions and QEF Inclusions. Moreover, it is arguably inconsistent with the statute to include items in NII that are not includible in "gross income", which is what the Proposed Regulations would do in the case of distributions of PTI.

This would not be the first time that Treasury and/or the IRS would have interpreted the word "dividend" in the Code to include Subpart F Inclusions and/or QEF Inclusions. The most notable precedent is the regulations interpreting Section 469(e)(1)(A). Section 469(e)(1)(A) states that income from a passive activity does not include "gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business". The regulations implementing this section of the Code provide that the language quoted in the prior sentence includes "all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to … *income (including dividends) from a … controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)…*"[73] This is a striking example of regulations interpreting the word "dividend" in the Code to include Subpart F Inclusions and QEF Inclusions. This is, however, not just any example. As discussed in the Main 1411 Report, Section 1411 relies in great part upon Section 469. It is clear that the words used by Congress to define the three categories of NII borrow from Section 469. In fact, the language defining Category 1 Income in Section 1441(c)(1)(A)(i) is substantially identical to the words used in Section 469(e)(1)(A). When Congress wrote Section 1411 it heavily relied upon the operation of Section 469 to define what income is or is not in NII. It seems eminently reasonable to conclude that the regulations under Section 1411(c)(1)(A)(i) could follow the regulations under Section 469(e)(1)(A) in interpreting the term "dividend" to include Subpart F Inclusions and QEF Inclusions.

Another example is in the context of the definition of unrelated business taxable income ("<u>UBTI</u>") in Section 512. Section 512(b)(1) provides that UBTI does not include "dividends"; the statute is silent as to whether Subpart F Inclusions and QEF Inclusions are also excluded from UBTI, and therefore the statute would appear to require that they be included in UBTI. However, beginning in the late 1980's, the IRS began issuing private letter rulings holding that, for purposes Section 512(b)(1), any Subpart F Inclusions would "be treated as if it were a dividend."[74]

In the early rulings, the IRS expressed the rationale for this conclusion as follows:

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73 Treas. Reg. section 1.469-2T(c)(3) (emphasis added).

74 PLR 9027051 (July 6, 1990) and 9024086 (June 15, 1990); See also PLR 8819034 (May 13, 1988)(same conclusion).

> The foreign personal holding company provisions (sections 551- 558) specifically provide that undistributed foreign personal holding company income is to be treated as a dividend. The Subpart F income rules were enacted in 1962 to supplement the foreign personal holding company rules. Thus, Subpart F income is taxed in largely the same manner as a dividend. *The mere fact that the timing of income recognition is accelerated under the Subpart F provisions, as under the foreign personal holding company provisions, does not result in treating the Subpart F inclusion any differently than distribution of an actual dividend in the absence of these rules, unless specifically provided elsewhere in the Code.*[75]

> Although the subpart F income will [not][sic] be distributed and is technically not a dividend, such income can be characterized as a constructive dividend due to the interaction of these sections of the Code [the Section 951 rules requiring that Subpart F Inclusions be included in gross income even though not distributed]. These sections produce a situation in which the income would be taxable on the part of shareholders as if it had been distributed by the subsidiary as a dividend, therefore, the income is functionally equivalent to a dividend. Consequently, this income will not be treated as unrelated business taxable income under section 512.[76]

> The mere fact that the timing of income recognition is accelerated under the Subpart F provisions, as under the foreign personal holding company provisions, does not result in treating the Subpart F inclusion any differently than distribution of an actual dividend in the absence of the Subpart F rules, except as specifically provided in the Internal Revenue Code and regulations. Therefore, any Subpart F income deemed to be received by P from C is treated as a dividend for purposes of the exclusion from unrelated business income contained in section 512(b)(1).[77]

After 1996, the IRS rulings had an even more compelling rationale—that there had been so-called "Congressional re-enactment" of the IRS' approach in the 1996 amendments adding Section 512(b)(17) and the accompanying legislative history. Section 512(b)(17) created a special rule for dividends and Subpart F Inclusions attributable to insurance activities conducted by a CFC; namely, those dividends and Subpart F Inclusions *are* included in UBTI. As to all other Subpart F Inclusions, the statute remained silent, but here is how the IRS describes what the legislative history had to say:

> The House Ways and Means Committee Report on the Small Business Job Protection Act of 1996, in describing section 512(b)(17), states that "income inclusions under Subpart F have been characterized as dividends for unrelated business income tax purposes."

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75 PLR 9024026 (March 15, 1990) (emphasis added).

76 PLR 8836037 (July 14, 1988).

77 PLR 8922047 (June 2, 1989).

> Prior to the enactment of section 512(b)(17) of the Code in 1996, …the Internal Revenue Service issued a series of private letter rulings stating that amounts distributed by the controlled foreign corporation (and thus includible in its shareholders' income under subpart F) were characterized as dividends for unrelated business income tax purposes and thus were not taxed. But a private letter ruling to the contrary was also issued. (PLR 9043039).
>
> …The House Ways and Means Committee Report on the new provision discusses favorably the rulings issued by the Service which characterized Subpart F inclusions as dividends and thus not taxable as unrelated business income.[78]

Another consideration is that the Proposed Regulations have already interpreted the word "dividend" to include substitute dividends and the word "interest" to include substitute interest; the rationale for doing so expressed in the Preamble is that taxation under Section 1411 should not be affected by "transactional formalities that are so readily manipulated by well-advised taxpayers" and that, in some contexts, it is appropriate to treat an item of income as an actual dividend, while in other contexts (e.g., the Section 1(h)(11) rules on qualified dividends) it is not:

> If substitute interest and substitute dividend payments were not treated in this manner, the Treasury Department and the IRS believe that taxpayers could easily avoid the section 1411 tax with respect to interest or dividend income by lending their securities over a payment date. The Treasury Department and the IRS do not believe that Congress intended the imposition of the section 1411 tax to turn on transactional formalities that are so readily manipulated by well-advised taxpayers. This approach is consistent with other contexts in which substitute interest and dividend payments have been treated in the same manner as actual interest or dividend payments in order to preclude avoidance of tax. For example, regulations under sections 861, 871, and 881 treat substitute interest and dividend payments as having the same source and the same character as the actual interest or dividend payments for which they substitute in order to preclude avoidance of nonresident withholding tax. See §§1.861-2(a)(7); 1.861-3(a)(6); 1.871-7(b)(2); and 1.881-2(b)(2).
>
> In certain other contexts, substitute payments are not treated in the same manner as actual interest or dividend payments (for example, a substitute dividend payment is not eligible for the dividends received deduction or for the lower rate of tax applicable to qualified dividends under section 1(h)(11)). In those contexts, however, disparate treatment serves essentially the same purpose, that is, to preclude the avoidance of tax through the multiplication of tax benefits or tax exclusions. The Treasury Department and the IRS believe that it is appropriate to treat substitute payments in a manner that precludes their use to facilitate tax avoidance. Accordingly, these proposed regulations treat substitute interest and

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[78] PLRs 200315034 (April 11, 2003), and 200251016 (Dec. 20, 2002); see also PLR 200315028 (April 11, 2003) (adding "The Committee Report also refers unfavorably to ruling 9043039 which used a look through rule to characterize subpart F income.")

substitute dividends as interest and dividends for purposes of determining net investment income.

We think that treating substitute dividends and substitute interest as "dividends" and "interest" within the meaning of Category 1 Income is a more significant expansion of the statute than would be treating Subpart F Inclusions and QEF Inclusions as dividends. In the case of substitute dividends and substitute interest, the Proposed Regulations subject to Section 1411 tax income that, based solely on the statutory language, would not otherwise be subject to this tax at all. By contrast, our recommendation to treat Subpart F Inclusions and QEF Inclusions (income that is subject to tax under Section 1411 when distributed) as dividends would only affect the timing of their inclusion in income for Section 1411 purposes and match the timing of their inclusion with that under Chapter 1.

We also think that not treating Subpart F Inclusions and QEF Inclusions as includible under Section 1411 at the same time as they are includible under Chapter 1 creates an opportunity for deferral of the Section 1411 tax in the very manner that the Subpart F and PFIC rules were intended to prevent (albeit for Chapter 1 purposes). We understand that individuals have been choosing to invest in offshore funds that are QEFs to avoid the limitations on the deductibility of miscellaneous itemized deductions and investment interest for federal and state income tax purposes that otherwise would apply if the individual had invested in a partnership. The ability to defer imposition of tax under Section 1411 would provide a further incentive for individuals to invest in such offshore funds.[79]

We also believe that a regulation treating Subpart F Inclusions and QEF Inclusions as Category 1 Income (or Category 3 Net Gain in the case of long-term capital gain QEF Inclusions) would be a reasonable interpretation of Section 1411 because it would reduce complexity and improve administrability of the Proposed Regulations. The Proposed Regulations create a complex new method of accounting for individuals who do not make G Elections. These individuals will have track separately their income from investments in CFC and QEFs, and their tax bases in the stock of CFCs and QEFs, for both Chapter 1 and Section 1411 purposes. The Proposed Regulations are very complicated when applied to S corporations and domestic partnerships that have shareholders or direct or indirect partners who are individuals who do not make G Elections. We have identified issues involving double counting and under counting of income under the Proposed Regulations. It is possible that other complex issues will arise once taxpayers and their advisors gain experience with the Proposed Regulations in their current form.

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[79] See David S. Miller, "*How U.S. Tax Law Encourages Investment through Tax Havens*, " Tax Notes Internat'l, Vol. 63, No. 6, 459 (Aug. 8, 2011).